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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Access Charge Review	CC Docket No. 96-262

REPLY COMMENTS
of the
GENERAL SERVICES ADMINISTRATION

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Summary

GSA responds to comments addressing the productivity offset, or "X–factor," included in interstate price cap plans to reflect the fact that telecommunications carriers are achieving productivity gains exceeding those for other segments of the economy.

Incumbent carrier parties contend that the Commission should reduce the X–factor employed in the present price cap plan. However, GSA explains that the Commission should reject these requests because competitive carriers and end users provide persuasive evidence that productivity offsets employed by the Commission over the decade have not been effective in constraining the LECs' prices. Unless the Commission prescribes increases in the X–factor — rather then reductions as the incumbent carriers request — interconnected carriers and end users will continue to pay too much for telecommunications services.

In the Notice, the Commission describes three approaches for developing the X–factor — Options 1 and 2 which rely on Total Factor Productivity data similar to that employed in recent years, and Option 3 which relies on a new "Imputed X Study" developed by the staff. Among the three options, incumbent LECs endorse Option 1, with several modifications.

GSA explains that Options 1 and 2 will not provide any better control over prices than observed in the recent past. Thus, GSA concurs with other end users that the Commission should adopt Option 3, which establishes the X–factor from direct measures of carriers' earnings.

By relying on direct analyses of the LECs' interstate costs and revenues, Option 3 offers significant advantages over the approaches using mathematical models to estimate historical changes in total factor productivity. Moreover, since Option 3 places minimal demands on the resources of the Commission and carriers, it can be updated each year to maintain a productivity offset reflecting current conditions.

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REPLY COMMENTS
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GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA") submits these Reply Comments on behalf of the customer interests of all Federal Executive Agencies ("FEAs") in response to the Commission's Further Notice of Proposed Rulemaking ("Notice") released on November 15, 1999. The Notice seeks comments and replies on represcription of the productivity offset in the interstate price cap formula.

I. INTRODUCTION

The interstate price cap plan contains a productivity offset, often called the "X–factor," to reflect the fact that local exchange carriers ("LECs") are expected to achieve productivity gains exceeding those for the economy as a whole. In the *1997 Price Cap Review Order*, the Commission set the productivity offset at 6.5 percent per year.[1] Several parties petitioned for judicial review of this action. Pursuant to these petitions,

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1 Notice, para 1, citing *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96–262, 12 FCC Rcd 16642 (1997) ("*1997 Price Cap Review Order*").

the U.S. Court of Appeals for the District of Columbia Circuit reversed and remanded the Commission's decision, but stayed issuance of its mandate until April 1, 2000 to permit the Commission to conduct the instant proceeding.[2]

The Commission seeks comments on the best approach for deriving the X–factor to be used in future years. The Commission suggests three possible approaches, and presents descriptions of these methods in appendices to the Notice.

GSA submitted Comments in response to the Notice on January 7, 2000. In its Comments, GSA explained that the productivity offsets in price cap formulas employed over the last decade have not provided reasonable constraints on the prices for interstate telecommunications services.[3] Although the Commission has increased the X–factor on two occasions, the interstate rates of return for major incumbent LECs have continued to escalate, and are now at all–time highs.[4]

GSA explained that the court's remand provides an opportunity for the Commission to establish a procedure for deriving a productivity offset that is more effective in controlling prices, more representative of current conditions, and easier to update as these conditions change.[5] To take advantage of this opportunity, GSA recommended that the Commission adopt Option 3, with annual updates.[6]

In addition to GSA, 14 parties submitted comments in response to the Notice. These parties include:

- 10 incumbent LECs and organizations of these carriers;
- 3 competitive LECs, other carriers and carrier associations; and
- an association of end users.

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2 *Id.*, para. 1 citing *USTA v. FCC*, 188 F.3d 521 (DC Cir. 1999).

3 Comments of GSA, pp. 2–8.

4 *Id.*, pp. 6–7.

5 *Id.*, pp. 9–14.

6 *Id.*

In these Reply Comments, GSA responds to the positions advanced by these parties.

II. THE COMMISSION SHOULD NOT ACCEPT INCUMBENT CARRIERS' REQUESTS TO REDUCE THE PRODUCTIVITY OFFSET.

A. Incumbent carriers assert that productivity changes justify a lower X–factor.

In the *LEC Price Cap Order* released in 1990, the Commission established an incentive–based price cap system as the regulatory procedure designed to work more efficiently in a competitive market.[7] Incumbent LECs under price cap regulation were required to share a portion of their earnings in excess of specified rates of return with their access customers by reducing the price cap for the subsequent period. The Commission prescribed two X–factors: a minimum 3.3 percent factor and an optional 4.4 percent factor.[8] Carriers electing to use the higher factor were permitted to retain larger shares of their earnings.

The *LEC Price Cap Order* contemplated that the Commission would review the performance of the price cap system periodically.[9] As a result of the initial review in 1995, the Commission increased the minimum X–factor from 3.3 percent to 4.0 percent, and established two optional X–factors of 4.7 percent and 5.3 percent, respectively.[10] In the next and most recent review order in 1997, the Commission revised the price cap plan by eliminating all sharing requirements and prescribing an X–factor of 6.5 percent.[11] The most recently prescribed 6.5 percent productivity offset

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7 *Policy and Rules Concerning rates for Dominant Carriers*, Second Report and Order, CC Docket No. 87–313, 5 FCC Rcd 6786, 6789 (1990) ("*LEC Price Cap Order*").

8 *Id.* at 6787.

9 *Id.* at 6789.

10 *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, CC Docket No. 94–1, 10 FCC Rcd 8961, 9055–9056 (1995) ("*1995 Price Cap Review Order*").

11 *1997 Price Cap Review Order*, 12 FCC Rcd at 16645.

reflects an estimate of 6.0 percent productivity growth and a consumer productivity dividend ("CPD") of 0.5 percent.[12]

In summary, the Commission has found it necessary to increase the X–factor to reflect significant increases in productivity in the telecommunications industry over the decade. Now, incumbent carriers ask the Commission to reverse this trend. The carriers urge the Commission to reduce the X-factor to provide them with greater flexibility in setting prices for interstate services.

The United States Telecom Association ("USTA") presents a study which purports to show that productivity increases have averaged about 4.0 percent in recent years.[13] Based on that study, USTA recommends that the X–factor be set no higher than 4.0 percent. Furthermore, since its data shows that productivity growth is "slowing down," USTA asserts that designation of a factor closer to 3.2 percent would be advisable.[14]

Similarly, BellSouth asserts that the Commission should prescribe an X–factor of 4.0 percent.[15] Moreover, BellSouth claims that "the Commission should concentrate on removing services from price cap regulation as quickly as possible, allowing market forces rather than regulatory fiat to set access prices."[16]

Mid–size and smaller LECs also contend that the productivity offset should be reduced. For example, Cincinnati Bell states that the CPD component of the productivity offset should be abolished.[17] Moreover, according to Cincinnati Bell, the

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12 *Id.*

13 Comments of USTA, p. 14.

14 *Id.*, p. 29.

15 Comments of BellSouth, p. 47.

16 *Id.*

17 Comments of Cincinnati Bell, p. 2.

Commission should set the X–factor for mid–size LECs at least one percentage point below the X–factor for larger LECs, regardless of their respective shares of the market.[18] In addition, Iowa Telecom, a carrier formed in 1999 to acquire all of GTE's access lines in Iowa, argues that the Commission should establish a lower X–factor for smaller and more rural LECs to encourage more participation in price cap regulation.[19]

B. Increased productivity offsets have not been sufficient to constrain the LECs' prices.

GSA urges the Commission to reject claims that the productivity offset should be reduced. Even with progressively increasing X–factors over the past decade, the system has failed to provide a reasonable "cap" on the rates and charges for interstate services.

As GSA explained, the experienced rates of return for LECs under price cap regulation provide the most dramatic evidence of the failure of the existing procedure to accurately reflect current productivity changes in the telecommunications industry.[20] According to a report published by the Industry Analysis Division, the 1998 interstate rates of return for Regional Bell Operating Companies ("RBOCs") ranged from 9.9 percent to 22.7 percent.[21] The unweighted average rate of return for these carriers was 15.33 percent, which is more than <u>four percentage points</u> above the 11.25 percent rate of return target employed in the universal service cost calculations.[22]

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18 id., pp. 8–10.

19 Comments of Iowa Telecom, pp. 1–4.

20 Comments of GSA, p. 5.

21 Industry Analysis Division, *Trends in Telephone Service*, September 1999 ("FCC Trends Report"), Table 15.1.

22 *Federal–State Joint Board on Universal Service*, CC Docket No. 96–45, Report and Order released May 8, 1997, para. 250.

Moreover, the mean rate of return for major price cap carriers increased continuously over the decade in spite of increases in the productivity offset, as shown in the table below.[23]

Rate of Return of Bell Operating Companies for 1991–1998

Year	Mean Rate of Return
1991	11.34 %
1992	12.77 %
1993	13.72 %
1994	13.86 %
1995	14.27 %
1996	14.83 %
1997	14.94 %
1998	15.33 %

Source: FCC Trends Report. The table shows simple averages of the carriers' rates of return in each year.

Indeed, the mean rate of return for the RBOCs has increased each year, and is now at an all–time high.

Not surprisingly, in their arguments for reductions in the X–factor, incumbent LECs avoid the issue of high and escalating earnings. To the extent that incumbent LECs address earnings results at all, they finesse the issue. For example, Iowa

23 Comments of GSA, p. 7.

Telecom stresses that "higher profits are consistent with the economic theory of price cap regulation."[24]

The LECs' opinion that procedures for establishing the productivity offset are basically sound ignores the fact that end users and interconnected carriers have been required to pay too much for telecommunications services. Users and interexchange carriers ("IXCs") provide ample evidence of this requirement in their comments responding to the Notice.

C. Competitive LECs and end users identify deficiencies in the procedures employed to estimate productivity changes.

The Ad Hoc Telecommunications Users Committee ("Ad Hoc") explains that price cap regulation itself, with the elimination of earnings sharing, has provided the major impetus for productivity improvements beyond those anticipated at each phase of the Commission's prescription process.[25] Also, Ad Hoc explains that studies proffered by USTA and incumbent carriers, which purport to show that productivity improvements have only been in the range of four percent, rely on data for <u>intrastate</u> services which are not encompassed in the Commission's price cap plan.[26] Furthermore, Ad Hoc explains that the staff's Imputed X Study validates observations concerning infirmities in the price cap system and supports the need for a substantial increase in the X–factor.[27] To summarize its findings, Ad Hoc states:

> In a turn of events suggesting that justice may sometimes be served, the record in this remand proceeding — a proceeding that the Commission initiated as a result of the price cap LECs' appellate

24 Comments of Iowa Telecom, pp. 9–10.

25 Comments of Ad Hoc, pp. 18–28.

26 *Id.*, p. 33.

27 *Id.*, pp. 29–32.

> assault on the Commission's prescription of a 6.5 percent X–factor — now calls for an X–factor substantially higher than 6.5 percent.[28]

In this vein, Ad Hoc explains that failure to increase the productivity offset will subject consumers to rate increases at a time when they should be enjoying rate reductions.[29] To ensure that consumers receive their share of the benefits of increased productivity, Ad Hoc recommends that the Commission increase the X–factor to at least 7.23 percent, and possibly to a value "over 10 percent."[30]

From its perspective as an interexchange carrier, MCI WorldCom ("WorldCom") also explains that insufficient productivity offsets have resulted in excessive charges for interstate services. WorldCom states, "Any examination of the X–factor used in the Commission's price cap plan must start from one incontrovertible fact — the LECs as a group have been able to achieve significant and continuing increases in earnings since price cap regulation began."[31] WorldCom observes that although the LECs' cost of capital has declined during the period, the carriers' overall earnings have risen from their 11.25 percent target at the start of price caps to more than 16 percent in 1998.[32] Moreover, WorldCom notes, increases in earnings occurred in years when the Commission increased the X–factor and required a one–time adjustment to give retroactive effect to the increase.[33] To address the significant improvements in productivity, WorldCom suggests that the Commission employ an X–factor between 7.2 and 10.0 percent.[34]

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28 *Id.*, p. i.

29 *Id.*, pp. 18–24.

30 *Id.*, p. i.

31 Comments of WorldCom, p. 3.

32 *Id.*

33 *Id.*

34 *Id.*, p. i.

AT&T Corp. ("AT&T") also identifies infirmities in the procedures for determining the productivity offset which have produced an X–factor that has been insufficient to keep pace with actual productivity improvements. For example, AT&T explains that the total factor productivity ("TFP") studies used to establish the X–factor in the past assume that all profits historically earned by the LECs represent a legitimate part of their cost of capital — a circular procedure that perpetuates a high rate of return.[35] Also, AT&T explains that the Commission's practice of calculating adjustments with data including intrastate costs and revenues understates productivity improvements, which have been greater in the interstate arena.[36] Prospectively, AT&T urges the Commission to adopt an X–factor of 9.6 percent.[37]

III. THE COMMISSION SHOULD REJECT CLAIMS THAT THE STAFF'S IMPUTED X STUDY HAS NO VALUE IN ESTABLISHING THE APPROPRIATE X–FACTOR.

A. Among the methods identified by the Commission, most incumbent LECs endorse Option 1.

Historical measures of productivity changes have been the principal determinants of X–factors employed in interstate price cap plans. In 1997, the Commission adopted a procedure for measuring past productivity changes by using models to estimate TFP increases for incumbent carriers. The TFP models employ three types of inputs — labor, material, and capital.[38]

In addition to the historical aggregate measures of productivity changes, each of the X–factors has included a CPD of 0.5 percent.[39] The CPD was included to provide

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35 Comments of AT&T, p. 6.

36 *Id.*, p. 8.

37 *Id.*, p. 5.

38 Notice, para. 13.

39 *Id.*, paras. 8–10.

additional benefits for ratepayers, and to account for the expectation that future productively growth would be greater because a more efficient regulatory scheme was being adopted.[40]

In the Notice, the Commission describes three options for determining the productivity offset to be employed for price cap carriers in future years:

> Option 1 Employ the staff's "1997 TFP study" with modifications to remedy the deficiencies observed by the court and several other deficiencies.
>
> Option 2 Use a "1999 TFP study," a new model developed by the staff which substitutes an independent measure of capital price changes for the changes used in the previous study and recalculates the effect on the compensation for capital inputs.
>
> Option 3 Employ an "Imputed X study" conducted by the Commission staff which determines from reported expenses and revenues the X–factor that would have produced a competitive level of capital compensation during the period between price cap reviews.[41]

Incumbent LECs support Option 1, which entails the least modification of the present procedures.

For example, USTA asserts that both the 1999 TFP Study and the Imputed X Study are flawed and should not be used to determine the X–factor.[42] USTA recommends that the Commission continue to employ the 1997 TFP, with updating and revisions described in USTA's comments and an accompanying statement.[43] USTA also recommends that the Commission eliminate the CPD.[44]

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40 *Id.*, para. 8.

41 *Id.*, paras. 2–3.

42 Comments of USTA, p. 5.

43 *Id.*, pp. 5–25.

44 *Id.*, p. 26.

From its perspective as a mid–size LEC, Cincinnati Bell offers a similar recommendation. This carrier urges the Commission to employ Option 1, which "addresses the Court's concerns and does not raise any new problems that would undoubtedly be subject to further appeals."[45] Similarly, Citizens Communications urges the Commission to employ Option 1 — to avoid introducing "new errors" — with the condition that the Commission prescribe a lesser X–factor for smaller LECs that are unable to achieve the operating efficiencies of the larger carriers.[46]

B. Comments by users demonstrate that Option 3 provides the best approach for setting the X–factor.

GSA acknowledges that Option 1 entails minimum changes in the procedures for estimating the productivity offset because it relies on the 1997 TFP studies. However, by changing the present system only to reflect specific deficiencies identified by the court — or even making additional modifications suggested by the staff and USTA — Option 1 will not be equal to the task of developing a productivity offset that will balance the interests of users and competitive carriers against those of incumbent LECs. Thus, GSA urged the Commission to adopt Option 3, which establishes the productivity offset from direct measures of earnings.[47]

GSA explained that Option 3 has many significant advantages. For example, the approach relies solely on reported interstate operating revenues, operating expenses, and net investments, as well as estimates of the elasticity of demand for interstate telephone services.[48] Also, this option avoids the arbitrary computational procedures questioned by the court, employs a modest amount of data that relates

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45 Comments of Cincinnati Bell, p. 2.

46 Comments of Citizens Communications, p. 3.

47 Comments of GSA, pp. 9–12.

48 *Id.*, p. 11.

directly to the carriers for whom it is to be applied, and requires relatively few assumptions that may be challenged.[49]

Ad Hoc also urges the Commission to employ Option 3 for determining the historical component of the X–factor.[50] In its comments, Ad Hoc confirms GSA's observation that use of this option would have indicated an X–factor increasing from 5.5 percent in 1995 to 8.51 percent in 1998.[51] Moreover, Ad Hoc observes that Option 3 has many additional advantages, including the use of interstate data that correctly reflect the greater price elasticity for interstate services.[52]

The principal objection by incumbent LECs to Option 3 is their claim that this approach abolishes the incentives for carriers to exceed a productivity goal. For example, SBC Communications asserts that "the Imputed X Study, which relies heavily on cost measures and ties X–factor changes directly to revenues, represents a complete abandonment of price cap regulation."[53]

GSA disagrees with this assessment. As GSA explained, Option 3 will not diminish the incentive for a LEC to maintain and increase its productivity.[54] Since the X–factor is established on the basis of industry experience, a LEC which exceeds industry productivity will earn more than its cost of capital. Of course, a LEC with lower–than–average productivity will experience lower earnings. The opportunity to earn a fair rate of return is not a guarantee, but LECs which consistently outperform the industry will be rewarded. The difficulty with price cap plans over the last decade has

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49 *Id.*

50 Comments of Ad Hoc, pp. 26–30.

51 *Id.*, p. 31; Comments of GSA, Table on p. 13.

52 Comments of Ad Hoc, p. 33.

53 Comments of SBC Communications, p. i.

54 Comments of GSA, pp. 11–12.

been that all LECs have been rewarded with higher earnings because of inadequate X–factors, even if their productivity performance was not superior to that of other carriers.[55]

In its Comments, GSA also explained that one of the most significant advantages of Option 3 is that updates can be implemented easily because of the simplicity of the inputs and computational procedures.[56] Ad Hoc similarly highlights this advantage, emphasizing that Option 3 is "computationally simple and easily understandable."[57] Moreover, Ad Hoc notes that Option 3 accommodates data for all price cap carriers, not just the RBOCs, which is a deficiency of the TFP studies used in Options 1 and 2.[58]

A system that can be updated more readily will be updated more often. With the rapid pace of change in telecommunications, it is vital to have the capability to adjust the productivity offset frequently and to establish its value on the basis of the most current data available.

Finally, for the reasons explained in its Initial Comments, GSA urges the Commission to adopt an annual review period for the productivity offset.[59] Also, GSA recommends that the offset be established on the basis of data portraying the most recent three year–to–year changes, with equal weight to each year.[60]

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55 *Id.*, p. 12.

56 *Id.*

57 Comments of Ad Hoc, p. 33.

58 *Id.*

59 Comments of GSA, pp. 12.

60 *Id.*

IV. CONCLUSION

As a major user of telecommunications services, GSA urges the Commission to implement the recommendations set forth in these Reply Comments.

Respectfully submitted,

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January 24, 2000

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I, MICHAEL J. ETTNER, do hereby certify that copies of the foregoing "Reply Comments of the General Services Administration" were served this 24th day of January, 2000, by hand delivery or postage paid to the following parties.

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